

Marginal Properties Workshop Meeting Minutes
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ISSUES INVOLVING BOTH PREPAYMENT AND ACCOUNTING RELIEF

1. Should regulations specifically define what constitutes a marginal property in terms of production? If so, should the same definition of marginal property be used for both sections 6 and 7 of RSFA?

The definition of marginal property (and corresponding production levels) as used in section 6 of RSFA should probably not be the same for section 7 because of the different purposes of these two sections. Section 6 is designed to keep small producers from going out of pocket to pay on entitlements, whereas the purpose of section 7 is to reduce administrative costs for industry and MMS and to encourage continued production from marginal properties.

The regulations should probably provide maximum levels of production for which applications for prepayment or accounting relief may be submitted. MMS should consider using state production incentive program requirements as the threshold for RSFA marginal property status. Most western states have incentive programs (generally for severance or production taxes) with

established production levels. The state of Colorado does not have such an incentive program. COPAS has compiled a listing of all known production incentive programs, both state and Federal, which is available for a fee (John Clark of COPAS will provide a copy to MMS). The Net Revenue Share program developed by OMM to encourage continued production on marginal economic offshore properties does not have established production levels and has an onerous application process. It was perceived that little use could be made of this program in determining offshore marginal property status for RSFA purposes. It was expressed by OMM personnel that marginal property status was probably best determined on a reservoir basis particularly in the case of the prepayment alternative. Tammy Naron of Apache volunteered to check with her offshore production personnel to help determine appropriate offshore marginal property production criteria.

Later discussion focused around at what level - property , reservoir, well, interest owner, or other- the marginal property alternatives could be made available. No decision was made and further research needs to be performed.

2. If a marginal property is to be defined in terms of production, should those production levels be determined on a nationwide basis or some other basis?

As discussed above, the marginal property definition probably needs to be unique for each state and based on the levels established under each states production incentive programs. Separate offshore property production criteria also needs to be established.

3. Should the regulations provide guidelines for prepayment or relief applications under section 7? If so, what information should be required with the application?

The regulations should provide only the highest levels of guidance. Detailed requirements for the content of the applications should be provided through a guidance paper similar to the guidelines developed for Extraordinary Cost Allowance applications. The guidelines will be developed with input from States and industry and will include examples. The section 7 application process should be as simple as possible.

The detailed requirements should be developed based on the results of several marginal property pilots. The pilots should include both prepayment requests and accounting relief requests, both oil and gas production, and both established declining production and newer marginal production. Bob Wilkinson suggested that Amoco may be interested in participating in a pilot for accounting relief and Patsy Bragg would check with Devon on possibly participating in a prepayment pilot situation. Other industry volunteers will also be sought to participate in these pilot activities.

It was further agreed generally that an application process for the marginal property alternatives was the appropriate vehicle as opposed to a notification process.

4. Should the regulations provide the Federal and State governments criteria for accepting or rejecting prepayment or relief applications under section 7? If so, what should the criteria be?

It was generally believed that the regulations should not contain these criteria. The regulations may however contain criteria which will necessarily cause the MMS or states to reject an

application. It was stated that the criteria for acceptance or rejection of a prepayment application may have to be on a case-by-case basis while general criteria for an accounting relief application may be mutually agreed to in advance by various MMS/state MOU's or other global guidelines. It was also believed that the MMS and individual states should internally develop these criteria. The pilots discussed above will also be useful in determining these criteria.

5. What provisions should be included in the regulations for State involvement in the application approval process? Should time frames for actions on the part of the lessee, the MMS, and the applicable State be delineated in the regulations? If so, what should those time frames be?

It was stated that by definition, time is of the essence for the marginal property alternatives, particularly accounting relief. We will coordinate with the 205 delegation team to determine how best and who to coordinate with in each State (Jim Detlefs is the MMS contact for that team). MMS and the states should attempt to process these applications within a six-month time frame (sooner if possible). It was stated that the experiences of the pilots will help to establish the time frames necessary for action on the part of each of the parties involved. It was further stated that the time frames would best be stated in the internally-generated guidelines, not in the regulations. Several commenters stated that since there is no consequence to the MMS or the states for delay on making their determinations, that there is no need to set forth time frames for such in the regulations.

ISSUES SPECIFIC TO ACCOUNTING RELIEF

1. What type of accounting, reporting (royalty and/or production), and auditing relief under section 7 should be considered to encourage lessees to continue to produce and develop marginal properties?

Some of the ideas expressed involved the following:

- Measurement or similar relief - Less frequent measurement of production and relief from other procedures which may significantly reduce operating costs to the lessee, encouraging continued production from the lease past what is otherwise currently possible
- Joint audit relief - Conduct BLM/MMS/State inspections or audits less frequently, with reduced scope, or in a more efficient manner to reduce costs to the lessee on properties which become marginal.
- Simplified, streamlined reporting - Check-stub type royalty reporting and paying with sufficient information to effect distribution by MMS to states and Explanation of Payment requirements specified in FOGRMA. Possibly do offline from AFS without use of Form MMS-2014.
- Reporting relief - Continue making monthly royalty payments but with periodic (quarterly annually, etc.) cumulative royalty reports (possibly on Form MMS-2014).
- Reporting and payment relief - Make royalty payments and reports once they cumulatively exceed a certain threshold (\$25 for example).

- Sliding-scale relief - A form of reporting and or auditing relief where greater relief is provided based on smaller volumes of production (some properties are more marginal than other properties and it may be appropriate to grant greater relief).

The following were noted with respect to the above proposals (and other discussion):

- There does not seem to be much potential for relief from monthly production reporting. BLM and OMM require the reports for purposes unrelated to royalty verification. Applicants may request relief from monthly production reports which may be considered on a case-by-case basis.

The MMS may not have any authority under the statutes or the lease terms to grant and form of relief from making monthly royalty payments. Debbie Gibbs Tschudy raised the point that the MMS may be required to pay the states interest if payment relief was granted. Patsy Bragg interpreted RSFA to provide that if the state acquiesced to a relief alternative that delayed payment that MMS would not have to pay interest to the state. The MMS will check with the Solicitor's office on these issues.

Some suggestions above apply marginal property status down to the working interest owner level, and would include properties which are not marginal, but small interest ownerships in larger properties which make the required royalty reports and payments of a marginal nature. This returned the discussion to what was intended as the definition of marginal property and what the statute intended. No decision was reached on this issue.

No specific proposals were advanced concerning auditing relief. Statements were made that some states audit every lease, no matter how insignificant the production. An observation that other provisions of the RSFA limit audits which are not cost beneficial. It was suggested that the lessee may propose limiting audits or audit scope within their application for relief.

2. Should the regulations provide for:

- a) one specified form of relief,
- b) optional forms of relief that may be requested by the lessee, or
- c) case-by-case relief as may be proposed by the lessee?

It was generally believed that the regulations should contain several agreed upon possible forms of relief, but that the lessee should be free to request any form of relief they may propose which the MMS or the state may accept, modify, reject, or propose an alternative form of relief.

3. How do the requirements of other initiatives such as the Stripper Oil Royalty Rate Reduction Program, which requires monthly reporting, impact the ability to provide reporting relief?

As discussed above, due to several requirements, there is little potential to provide relief from monthly production reporting. The lessee may request monthly production reporting relief

which should be considered on a case-by-case basis.

ISSUES SPECIFIC TO PREPAYMENT

There was general agreement on the following prepayment issues:

- 1.MMS will publish broad prepayment regulations that are supported by general guidance and standards. Because each State must approve the prepayment, and each State will have their own criteria for accepting a prepayment, it is impossible to include much detail in the regulations.
- 2.A company will submit an **application** to prepay that includes the prepayment calculation. In certain "hardship" cases, i.e. small companies w/out the resources to perform the calculations, MMS will calculate the prepayment amount. We will spell out these "hardship" cases in the regulations.
- 3.The regulations will not specify a formula to use for the prepayment calculation. They will, however, include certain criteria MMS will use to evaluate the prepayment. These criteria could include the discount rate and price forecasts.
- 4.The prepayment will be reported on the 2014 with a unique transaction code that bypasses most 2014 edits - much as settlement monies are currently reported.
- 5.The "floor" on any prepayment will be the discounted minimum royalty over the estimated life of the marginal property.
- 6.The **periodic production report** mentioned in the law will more than likely become the **monthly** 3160 or OGOR, as currently required. See notes from previous section.

There was not general agreement on the following prepayment issues:

- 1.Definition of marginal property. See notes from previous section.
- 2.The provision allowing MMS to collect additional royalty for developments . . . that deviate significantly . . . from the assumptions made in the prepayment valuation raised many concerns. Industry favors a tight definition of "deviate significantly" so that we cannot second guess the prepayment on a whim. One suggestion was that if the actual reserves exceed the estimated reserves by a certain percentage - say 30% - then additional royalties are due. Additional royalties are not due if the actual prices exceed the estimates.
- 3.Along the "deviate significantly" lines, how should new production be handled? Would it be treated separately from the prepaid production and reported like "normal" royalty or would the property have to re-qualify for the marginal property and prepayment exceptions?

Other Prepayment Items

MMS will research how DOE sells production from the Strategic Petroleum Reserve and the Naval Oil Shale program. This might give us insight into the discount rate and price projection

questions. MMS will also research DOE's EIA price forecasts.

More discussion is needed to determine what role BLM and OMM will play in the prepayment calculation .

Industry will find volunteers to participate in a prepayment pilot. Devon Energy was mentioned.

The State outreach for both prepayment and accounting exceptions should include all States with Federal production and not just the delegable States because State approval of any exception is mandatory.

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